Testimony before the Committee on Ways and Means,
United States House of Representatives
Washington, DC
May 12, 2011

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Mr. Chairman and Members of this distinguished Committee, it is an honor to participate in these hearings on international tax reform. I teach at the University of Michigan, where I am Richard A. Musgrave Collegiate Professor of Economics in the department of economics, L. Hart Wright Collegiate Professor of Law in the law school, and Research Director of the business school's Office of Tax Policy Research. I am also a Research Associate of the National Bureau of Economic Research, Research Director of the International Tax Policy Forum, and Co-Editor of the Journal of Public Economics.

The United States faces significant economic challenges, but Congress has the opportunity to improve the performance of the U.S. economy, and the economic prospects of American workers, through changes to our tax system. The current U.S. system of taxing the worldwide incomes of American firms impairs their ability to compete for business in global markets, and distorts the ownership of productive assets in the United States and abroad, thereby undermining the vitality of the American economy. Changing the taxation of American businesses in a way that makes it more consistent with the tax systems of other major economies would permit Americans to compete on an equal basis with foreign firms, improve the efficiency of resource allocation in the United States, and strengthen demand for the services of American workers.

The United States is currently unique among major capital exporting countries in taxing foreign income as heavily as we do. The United States subjects active foreign business income to domestic taxation, and in a manner that strictly limits the ability of taxpayers to claim foreign tax credits and to avoid current U.S. taxation of unrepatriated foreign income. There are aspects of the U.S. tax system that limit burdens on foreign income: in particular, taxpayers are generally entitled to claim credits for foreign income tax payments, and there are many circumstances in which U.S. taxation is deferred until income is repatriated. But every other major capital exporting country exempts active foreign business income from taxation, and even among the countries that do tax foreign income, their rules for claiming foreign tax credits and deferring home country taxation of foreign income are far less draconian than those of the United States.

What are the consequences of taxing foreign income so much more heavily than does any other major capital exporting country? American firms are put at competitive disadvantages relative to firms from Britain, Germany, Canada, Japan and elsewhere in competing for business opportunities in global markets. Most of foreign direct investment represents acquisitions of existing companies, whose assets and activities the new acquirer can then deploy to good advantage. An example would be an American firm with intellectual property and business know-how developed in the United States that seeks to acquire a firm in Spain – whose operations, the potential acquirer believes, would be enhanced by adopting some of its own practices and technologies. If the price is right, the acquisition would go through, and should be expected subsequently to encourage even greater business activity in the United States, since the return to the development of new product lines and business practices by the U.S. parent company would then be enhanced by their potential exploitation by the Spanish affiliate. The difficulty is that, since the U.S. tax system imposes a cost that the German tax system does not,

potential German acquirers may be able to outbid Americans simply on the basis of tax differences. As a result, the Spanish firm may wind up with German ownership even though the more efficient owner would be an American company. The inefficiency thereby created depresses the return to business activity in the United States, a cost that is borne largely by American workers in the form of lower wages and reduced employment prospects.

The U.S. tax system generally discourages foreign investment by imposing a tax on repatriated active business income. In addition, the United States taxes certain forms of unrepatriated income, limits the ability of U.S. taxpayers to claim foreign tax credits if they have certain domestic expense deductions, and discourages firms from repatriating income to the United States. The impact of the U.S. rules is to change the business practices of American taxpayers in a manner that is inconsistent with the practices of firms from other countries with which they compete, and inconsistent with practices that would otherwise maximize pretax profits. It is certainly unwise to have a tax system that distorts and depresses American business activity, and it is curious to have a tax system that looks so very different from the tax systems of other major capital exporting nations, indeed, a system that most countries have chosen to abandon.

A seductive, but ultimately misleading, and perhaps even tragic, logic lies behind the U.S. system of taxing the worldwide incomes of American businesses. This logic holds that it is appropriate for the U.S. tax system to subject all income to taxation at the same rate. This proposition is inconsistent with economic efficiency and with the realities of global competition. Despite these inconsistencies, it serves as the basis of the 1960s notion of capital export neutrality that remarkably still influences the thinking of some who advocate in favor of taxing the worldwide incomes of American firms. In fact, the capital export neutrality logic goes quite

a bit further than that, in that it implies that the United States acting on its own behalf should not permit taxpayers to defer U.S. taxation of unrepatriated foreign profits, and also implies that taxpayers should not be entitled to claim foreign tax credits for foreign tax payments. By this way of thinking, the problem with the current U.S. tax system is that we do not tax foreign income heavily enough. It is irrelevant, so this argument goes, that we already tax foreign income more heavily than do other countries – because the theory is constructed in a way that ignores the impact of foreign tax systems and the activities of foreign companies.

The capital export neutrality paradigm has been decisively rejected by modern scholars, whose models and evidence incorporate the actions of other countries and the operation of the global marketplace, and by governments around the world, who do not seek to tax the active foreign incomes of their resident companies. It is now generally understood that efforts to tax active foreign income reduce the efficiency of a country's tax system, and thereby reduce the returns earned by a country's productive factors. Unfortunately, capital export neutrality lives on in Washington DC, in the form of the U.S. income tax.

To those who accept the logic of capital export neutrality, who believe that it is important to continue to tax the foreign incomes of American businesses, or worse, to stiffen the taxation of foreign income by further limiting the ability of American taxpayers to defer U.S. taxation of unrepatriated profits, it is worth asking why the U.S. tax system should restrict itself to such limited moves. The logic of capital import neutrality implies that the United States, acting on its own behalf, would benefit from repealing the foreign tax credit, permitting taxpayers only to deduct foreign income tax payments. Furthermore, the logic implies that the United States should give global scope not only to its income tax, but also to its excise, property, sales, and other taxes.

What would happen if the U.S. federal government were to levy a $2 tax on each gallon of gasoline sold in the United States and sold abroad by persons resident in the United States? Suppose that this system permitted American taxpayers to claim foreign tax credits for excise taxes paid to foreign governments, so that a U.S. firm selling gasoline in a country whose excise tax rate exceeds $2 per gallon would owe no additional tax to the United States, whereas a firm selling gasoline in a country with a $1.25 per gallon tax would owe $0.75 per gallon to the United States. One could imagine permitting worldwide averaging, thereby permitting taxpayers to use excess excise tax credits from sales in jurisdictions with excise taxes exceeding $2 per gallon to claim credits to offset taxes due on sales in jurisdictions with excise taxes less than $2 per gallon.

What would be the impact of such an excise tax regime? Firms selling in countries with excise taxes exceeding the U.S. rate would have excess foreign tax credits and therefore no U.S. tax obligations, so the tax regime would not affect them. Firms without excess foreign tax credits would face U.S. excise taxes on foreign sales that vary with local excise tax rates. Odd though such a system would be, it might not spell the end of foreign gasoline sales by American companies in all low-tax jurisdictions, though that is a distinct possibility. American companies would persist in selling gasoline in those foreign markets in which they are both profitable and unable to earn even more by selling their operations to foreign petroleum companies not subject to the U.S. tax regime; otherwise, they would be likely to disappear from those markets, to be replaced by foreign petroleum companies.

The economic costs of a residence-based excise tax regime are simple to identify. American firms lose the opportunity to earn profits in foreign markets from which they are driven by U.S. excise taxes, and this, in turn, reduces the rate of return to domestic activities that

make foreign operations otherwise profitable. Since there is every reason to believe that a worldwide excise tax regime would have very significant effects on the participation of American firms in foreign markets, the associated economic costs are potentially enormous. The tax crediting mechanism creates an odd pattern of U.S. excise taxes on foreign operations, with zero and even (in some cases) negative excise taxes on foreign sales in some countries, whereas in other countries the U.S. system imposes positive tax rates that vary with local excises. Even in circumstances in which American firms sell in foreign markets despite the imposition of significant U.S. excise taxes on such sales, the volume of foreign activity will be reduced, and distorted among countries, as a result of such taxes.

What possible justification could be offered for a home-country excise tax regime such as that just described? Many, if not all, of the same arguments commonly advanced in favor of worldwide income taxation would apply with equal force to worldwide excise taxation. From the standpoint of the world as a whole, the benefits of selling an additional gallon of gasoline equals the benefit to consumers, which in turn is measured by the (tax-inclusive) price that consumers pay for the gasoline. Since sellers receive only the tax-exclusive price of gasoline, their incentives do not correspond to global efficiency except in the unlikely event that excise tax rates are the same everywhere. In the absence of residence-based worldwide excise taxation, too few gallons of gasoline will be consumed in countries with high excise tax rates, and (relatively) too many in countries with low excise tax rates. Domestic excise taxation might be said to encourage American firms to move their sales offshore. A system of residence-based taxation in effect harmonizes excise taxes around the world from the standpoint of domestic producers.

An analogous argument would apply to domestic welfare, which, by the standard logic, is maximized by a worldwide excise tax regime even less generous than that under consideration.

Domestic welfare, the thinking would go, is maximized by subjecting foreign sales to domestic excise taxation without provision of foreign tax credits. The reason is that, from the standpoint of the United States, the value of selling a marginal gallon of gasoline in a foreign market equals the profit that it generates, whereas the value of selling a marginal gallon of gasoline in the United States equals the profit it generates plus the associated excise tax revenue. Equating these two requires that the United States impose equal excise taxes on foreign and domestic sales.

One simple and entirely reasonable objection to subjecting foreign sales to home country excise taxation is that excise taxes tend to be incorporated in sales prices, so that, for example, increasing a (commonly used today; destination-based) excise tax on gasoline by $0.10 per gallon tends to be associated with roughly $0.10 per gallon higher gasoline prices. Of course, this incidence is unlikely to be exact, and indeed, both theoretical and empirical studies of sales tax incidence find that prices can move by less than, or in some cases more than, changes in excise tax rates. But the efficiency argument is valid on its own terms regardless of the incidence of the tax. That is, the argument is unchanged whether or not gasoline taxes are incorporated fully in consumer prices. Furthermore, and this is the underlying point, the same argument that consumer prices incorporate excise taxes applies to corporate income taxes, and for the same reason: both excise taxes and corporate income taxes increase the cost of doing business, and market forces translate higher costs into higher consumer prices.

The same argument applies with equal force beyond excise taxes to worldwide residence-based taxation of state property and sales taxes. How are taxpayers likely to respond to the introduction such residence-based taxation? The obvious reaction is to shed, or avoid in the first place, ownership of activities in jurisdictions where it would trigger significant tax liabilities. Again, it does not follow that American firms would maintain no foreign operations; it is almost

certain that they would continue at least some operations, despite the tax cost. But the distortion to ownership, investment, and productivity would be enormous.

The older efficiency norms that underlie capital export neutrality and related concepts would evaluate residence-based worldwide excise, property, and sales taxation favorably. Policies that allocate economic activity around the world based on pretax returns maximize world welfare, so the capital export neutrality logic implies that total (host country plus home country) tax rates should be the same everywhere. In the absence of worldwide tax harmonization, this can only be achieved by home country tax regimes that offset any differences between domestic and foreign taxation. Home-country welfare would be maximized by a different regime, in which after-foreign-tax returns are subject to home country taxation at the normal rate, so by this reasoning maximizing home welfare implies that taxpayers should not be entitled to foreign tax credits.

No country attempts to tax sales or property on a residence basis, doubtless deterred by some of the considerations that are apparent from the preceding discussion. The reason to analyze worldwide sales or property taxation is not because they might realistically be adopted by the United States or some other government in the near future, or because they contain desirable features, but instead for the light that they shed on residence-based systems of taxing corporate income earned in other countries. To put the matter directly: why is it that residence-based excise, sales, and property taxation are clearly undesirable policies, while residence-based income taxation has not enjoyed the same unpopularity in the United States?

Residence-based taxation of foreign income has the same ownership effects as would residence-based excise, sales, or property taxation, with the same (negative) impact on economic

welfare. The economic consequences of income taxation seem subtler than those of, say, excise taxation, but this is merely an illusion, since a $10 million tax liability associated with American ownership will discourage U.S. ownership of foreign business assets to the same extent whether the $10 million is called an income tax or an excise tax.

It is this distortion to ownership that produces the largest component of the efficiency cost associated with the U.S. regime of worldwide taxation. Compared to other countries, the U.S. system of taxing foreign income discourages foreign asset ownership generally, and in particular discourages the ownership of assets in low-tax foreign countries. Mihir Desai, and I have estimated the net tax burden on American firms from the U.S. system of worldwide taxation to be in the neighborhood of $50 billion per year, well exceeding revenue collections, since a significant portion of the net burden comes in the form of the associated efficiency cost.

What would be the consequence of exempting active foreign business income from U.S. taxation? The greater productivity associated with improved incentives for asset ownership would enhance the productivity of factors that are fixed in the United States, specifically including land but primarily labor, and thereby increase the returns that they would earn. Studies, including some of my own recent statistical work with Mihir Desai and Fritz Foley, generally find that 70 percent or more of the corporate income tax burden is borne by labor in the form of lower wages. This is likely to be at least as true of international corporate tax provisions as it is of corporate taxes generally.

What would be the domestic consequences of reducing the taxation of foreign income and thereby rationalizing the demand for foreign assets by American firms? One of the concerns that naturally arises is the possibility that reduced taxes would encourage greater foreign activity on the part of American firms, who would then substitute foreign for domestic employment, to

the detriment of American workers. In evaluating this concern it is important first to note that the actions of British, German, and other foreign firms themselves potentially influenced by what American firms do, so that if American firms were to contract their U.S. operations then foreign firms are likely to replace them by expanding their U.S. operations, and if this reallocation of activity is efficient, then it should be accompanied by even greater demand for American labor. The second point, however, is that it is far from clear that greater foreign activity by American firms comes at the cost of their domestic activities.

There are examples of instances in which American firms have substituted foreign for domestic labor input; but there are also many examples of instances in which the ability to exploit business opportunities abroad enhances the value of, and the demand for, American labor. In many modern industries it is impossible for a large firm to maintain a high level of domestic productivity without also engaging in business activities around the world. From the standpoint of their demand for American labor, foreign expansions by American firms entail what are often countervailing substitution and productivity effects: foreign employment is a substitute for American employment, but foreign business operations also enhance the productivity of American business operations, thereby stimulating greater demand for American employment. The same logic applies to capital investment, so levels of capital investment in the United States might be positively or negatively affected by foreign investment by American firms. The statistical question is whether the substitution or the productivity effect dominates for the typical American firm.

There is a flurry of recent statistical evidence suggesting that greater outbound foreign direct investment does not reduce the size of the domestic capital stock, but instead increases it. This evidence includes a study of my own with Mihir Desai and Fritz Foley, examining the

aggregate behavior of U.S. multinational firms over a number of years, but also includes aggregate evidence for Australia, industry-level studies of German and Canadian firms, and firm-level evidence for the United States, the United Kingdom, and Germany. In a recent firm-level study of my own with Mihir Desai and Fritz Foley, we find that for American firms between 1982 and 2004, 10 percent greater foreign capital investment is associated with 2.6 percent greater domestic investment, and 10 percent greater foreign employment is associated with 3.7 percent greater domestic employment. Foreign investment also has positive estimated effects on domestic exports and research and development spending, indicating that foreign expansions stimulate demand for tangible and intangible domestic output.

Hence there are good reasons to think that exempting active foreign business income from U.S. taxation would stimulate greater economic activity in the United States. It follows that the opposite is also true: reforms that would curtail the ability of U.S. taxpayers to defer home country taxation of foreign profits or the ability to claim foreign tax credits would reduce the productivity of U.S. business operations and thereby reduce economic activity in the United States.

One of the striking aspects of viewing international income taxation through the lens of its impact on asset ownership is that this perspective offers important implications for the treatment of domestic expenses by firms with foreign income. Businesses engaging in worldwide production typically incur significant costs that are difficult to attribute directly to income produced in certain locations. Important examples of such expenses include those for interest payments and general administrative overhead. There is a very important question of how these expenses should be treated for tax purposes. Practices differ in countries around the world, and indeed, U.S. practice has varied over time, but the current U.S. tax treatment is

squarely on the side of allocating domestic expenses between foreign and domestic income based on simple indicators of economic activity. Thus, for example, an American multinational firm with 100 of domestic interest expense is not permitted to claim as many foreign tax credits as is an otherwise-equivalent American firm without the interest expense, reflecting the theory that a portion of the borrowing on which interest is due went to finance foreign investment.

Expense allocation of the variety embodied in current U.S. tax law has a decided intuitive appeal. It carries the general implication that domestic expenses that are incurred in the production of foreign income that is exempt from U.S. taxation (as is the case, for example, of income earned in countries with very high tax rates, for which foreign tax credits are available) are effectively not permitted domestic tax deductions (via an equivalent reduction in foreign tax credit limits). While there is much to be improved in the details of the current U.S. rules governing expense allocation, the general structure of expense allocation is largely consistent with the rest of the U.S. system of attempting to tax foreign income in a manner that vaguely embodies the principle of capital export neutrality.

Taking as a premise that capital export neutrality is an unsatisfactory basis for taxing foreign income, and that the United States would instead prefer to exempt foreign income from taxation based on the same capital ownership considerations that make the United States prefer not to impose worldwide excise taxes, then what kind of expense allocation regime properly accompanies the exemption of foreign-source dividends from domestic taxation? The answer is that domestic expenses must not be allocated at all, but instead traced to their uses, as most countries other than the United States currently treat interest expense. To put the same matter differently, tax systems should permit taxpayers to allocate general expenses that cannot be directly attributed to identifiable uses in such a way that they are fully deductible in the country

in which they are incurred (this assumes that governments will not permit deductions for general expenses incurred in other countries, as is indeed the universal practice).

In order to understand the logic behind permitting the full deductibility of domestic expenses, it is helpful to start by noting that any other system of expense allocation will have the effect of distorting ownership by changing the cost of foreign investment. Consider the case of a firm with both foreign and domestic income, and 150 of expenses incurred domestically in the course of activities that help the firm generally, and thereby arguably contribute both to domestic and foreign income production. One sensible-looking rule would be to allocate the 150 of expenses according to income production, so that if the firm earns half of its income abroad and half at home, with the foreign half exempt from domestic taxation, then the firm would be entitled to deduct only 75 of its expenses against its domestic taxable income. For a firm with a given level of general domestic expenses, greater foreign investment would then be associated with reduced domestic deductions, and therefore greater domestic taxes. Hence the home country would in fact impose a tax on foreign income, in the sense of discouraging foreign investment and triggering additional domestic tax collections for every additional dollar of foreign investment. The only sense in which this tax differs from a more conventional tax on foreign income is that it does not vary with the rate of foreign profitability.

The fact that a simpleminded expense allocation rule acts just like a tax on foreign investment might at first suggest that those who design policy should seek alternative expense allocation systems that do not create these incentives. Unfortunately, there is no clever solution available to this problem: any system that allocates expenses based on a taxpayer's behavior will have the effect of influencing that behavior, in the same way that a more conventional tax would. An alternative system of tracing expenses, in which taxpayers determine and report the uses to

which deductible expenses are put, does not have this feature but creates ample opportunities for tax avoidance. Hence policies designed to avoid taxing foreign income necessarily must forego allocating expenses incurred domestically.

This implication of foreign income exemption seems to run afoul of obvious objections from the standpoint of tax arbitrage. Why should the United States permit taxpayers to borrow in the United States, using the proceeds to invest abroad, and thereby earn income that is exempt from U.S. tax while claiming deductions against other U.S. taxable income for the cost of their borrowing? Even the observation that this is exactly what many other countries do has the feel of not fully addressing this issue. The answer lies in the fact that greater foreign investment triggers added domestic investment, so from the standpoint of the U.S. tax system, the borrowing does not simply generate uncompensated interest deductions, but instead a domestic tax base that is equivalent to (quite possibly greater than) the tax base that would be forthcoming if the borrowing proceeds were invested domestically by the same entity that does the borrowing.

The same point can be considered from the standpoint of the taxpayer. An American multinational firm with domestic and foreign operations should be indifferent, at the margin, between investing an additional dollar at home or abroad; if not, the firm is not maximizing profits. Hence when the firm borrows an additional dollar to invest abroad, it might as well invest at home, since the two produce equivalent after-tax returns – and it is clear that if a purely domestic firm borrows to undertake a domestic investment, it is entitled to deductions for its interest expenses.

Part of the confusion that surrounds the treatment of interest expenses (and other general expenses that firms incur and that are difficult to assign to particular lines of business) is that,

from a tax standpoint, the marginal source of investment finance matters greatly. That said, the marginal source of investment finance is extremely difficult to pinpoint. Debt finance is generally preferred to equity finance on the basis of tax considerations, since in a classical corporate income tax system such as that practiced by the United States, interest expenses are tax deductible whereas dividend payments to shareholders are not. Hence debt finance might be thought of as a worst case scenario from the standpoint of raising corporate tax revenue; with appropriate income measurement, marginal debt-financed domestic investments generate no tax revenue, and with inappropriate income measurement, these investments might generate positive or negative tax revenue.

If the goal of a tax system is properly to raise revenue while offering appropriate economic incentives, and these are understood to include efficient incentives for capital ownership, then the simple exemption of foreign income from taxation is insufficient without accompanying expense allocation rules. Exempting foreign income from taxation gives taxpayers incentives to allocate their resources to maximize after-local-tax profits only if there is no unwinding of these incentives through expense allocation that depends on where income is earned or where other expenses are incurred. Using a system of expense tracing that in practice often entails full deductibility of domestic expenses need not be viewed as a daring step. The same logic that underlies the efficiency rationale behind exempting foreign income in the first place also implies that expenses should be deductible where incurred.

There are sure to be both revenue concerns and other concerns associated with a reform that exempts foreign income from taxation and permits tracing for domestic expenses. Removal of U.S. taxation of active foreign business income would increase the importance of effective enforcement of the transfer pricing rules and other rules designed to protect the U.S. tax base. It

would, however, be a mistake to maintain the current regime of taxing foreign income simply out of concern over base erosion of this type, given that there are many ways of addressing these issues. For example, elimination of U.S. taxation of active foreign business income might be accompanied by allocating significant additional resources to the Internal Revenue Service for use in international enforcement. Given the alternatives before us, it would be a serious mistake to think that enforcement concerns alone dictate the maintenance of an inefficient system of taxing worldwide income.

The question to ask going forward is what is the alternative to exempting foreign income from taxation? The alternative is one in which American businesses continue to face inefficient incentives for asset ownership, incentives that their competitors from most of the rest of the world do not face. The inefficiencies for which these incentives are responsible continue to erode American living standards, not acutely, but gradually and relentlessly, thereby contributing to an economic situation in the United States that is not as promising as it might otherwise be. If worldwide taxation of active business income is a good idea, then is it not also just as good an idea to subject the foreign operations of American firms to U.S. excise taxation, sales taxation, and property taxation? And if not, what does that tell us about worldwide income taxation?

Exempting foreign income from taxation, and permitting full deductibility of domestic expenses, would promote efficient ownership of productive assets, domestic and foreign, by American businesses and foreign investors in the United States. Such a policy would contribute to the vitality of the U.S. economy, the benefits of which would be felt primarily by U.S. workers in the form of greater employment opportunities and higher wages. Efforts to move in the other direction by limiting deferral of home country taxes, or limiting the extent to which taxpayers can claim credits for foreign tax payments, would have the unfortunate effect of reducing the

productivity of U.S. business operations, thereby reducing the welfare of U.S. residents, again primarily affecting American workers. There has never been a time when the United States would benefit from inefficient tax policies, and now is certainly not the time. The alternative of exempting foreign income and permitting domestic expense deductions is hardly a bold step, given that every G-7 nation other than the United States has already taken it, and it is one from which our economy would substantially benefit.